Risk Perspectives

Highlights of Risk Monitoring in the Seventh District – 3rd and 4th Quarters 2013

The Federal Reserve Bank of Chicago (Seventh District) Supervision & Regulation Department tracks current and emerging risk trends on an ongoing basis. This *Risk Perspectives* newsletter is designed to highlight a few of the timeliest themes for the Seventh District's supervised financial institutions. This newsletter is not intended to be an exhaustive list of the current or potential risks and should not be relied upon as such. We encourage each of our supervised financial institutions to keep abreast of risk trends most relevant to their individual operations and business models.

Regulatory Capital Rules Finalized

As noted in the *Risk Perspectives* issue from the second quarter of 2013, the Federal Reserve in July 2013 enacted a new regulatory capital rule following a lengthy period for public comments and revisions. The new rule serves as U.S. supervisors' implementation of the international Basel III accord, designed to increase the quantity and quality of capital held by various types of financial institutions. The new capital rule applies to banks, bank holding companies, savings associations, and savings and loan holding companies, with very few exceptions.

The rule sets forth a new regulatory capital ratio, known as the "common equity tier 1 capital ratio," which is designed to measure the highest quality loss-absorbing capital on an institution's balance sheet. Other provisions of the rule include increasing the minimum tier 1 risk-based capital ratio requirement from 4% to 6%; modifying the calculation of risk-weighted assets; and establishing a capital buffer that companies of all sizes must meet before making any capital distributions and/or incentive compensation payments. Several of the largest banking organizations in the country will also be subject to two additional capital requirements: a countercyclical capital buffer, which aims to encourage companies to accumulate capital during periods of economic strength, and a newly defined supplementary leverage ratio, which takes into account off-balance sheet exposures.

In addition to the provisions of the final rule enacted in July, the Federal Reserve has proposed a new rule that, if finalized, would hold eight of the largest banking organizations to a higher supplementary leverage ratio standard. The existing rule and proposed rule, taken together, are important regulatory tools for promoting financial stability.

Supervisory Guidance

The Federal Reserve Board of Governors periodically releases Supervision and Regulation Letters, commonly known as SR Letters, to address significant policy and procedural matters related to the Federal Reserve System's supervisory responsibilities. Included on the following page are some of the SR Letters released in the third and fourth quarters of 2013. A complete listing of SR Letters is available on the Federal Reserve Board's website.

SR 13-25	Interagency Statement Regarding the Treatment of Certain Collateralized Debt Obligations Backed by Trust Preferred Securities under the Volcker Rule
SR 13-21	Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less
SR 13-20/CA 13-23	Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans
SR 13-19/CA 13-21	Guidance on Managing Outsourcing Risk
SR 13-15 / CA 13-11	Federal Reserve Resources for Minority Depository Institutions
SR 13-14	Timing Standards for the Completion of Safety-and-Soundness Examination and Inspection Reports for Community Banking Organizations

Current Risk Topics

The Emerging Fraud Environment

A recent report by the Financial Crimes Enforcement Network (FinCEN) included a nationwide analysis of suspicious activity reports (SARs) and found a rise in fraud activity from 2011 to 2012. Incidence of identity theft accelerated at a high rate, as did abuse of customer information at depository institutions by both internal and external parties. Stolen customer information is being used to perpetrate various types of fraud, including consumer loan fraud, credit/debit card fraud, wire transfer fraud, ACH and check fraud. Although rates of mortgage loan fraud declined during the same time period, it continues to be an issue, notably from foreclosure rescue scams, short sales, and loan modification schemes.

With new fraud schemes appearing almost daily, boards of directors and bank management teams should both stay aware of current fraud trends and how their institution is positioned to deal with new potential threats. Institutions are also advised to continuously reassess their fraud risk governance and mitigation process to keep pace with the changing environment. Fraud risk assessments, hotlines and anti-fraud controls are an effective way to understand, manage, and mitigate fraud risk. Fraud mitigation efforts throughout the organization and across business lines should to be consolidated in an institution’s overall governance framework.

Leveraged Lending

In the years preceding the financial crisis, issuance of leveraged loans reached record levels. The rapid pre-crisis rise in outstanding balances coincided with a pervasive use of “covenant lite” loan structures even as average debt multiples among large corporate leveraged loan borrowers exceeded 6.0x. As the crisis unfolded, market liquidity evaporated and syndications failed, forcing banks to mark down assets. Defaults rose sharply, from $1 billion in 2007 to over $70 billion in 2009 as obligor performance deteriorated dramatically. Many transactions never found permanent financing and continue to languish today.

Pre-crisis Weakness in Leveraged Lending

- The Role of Leverage: 30% of defaults had leverage over 6.0x and nearly 80% of defaults had leverage of 4.0x or greater.
- Minimal Amortization Requirements and Payment in Kind (PIK) toggles: Weak loan structures, most notably covenant-lite transactions, left banks and investors unable to reduce exposures or enforce rights.
- Bifurcated Underwriting: Institutions commonly used separate underwriting standards for to-be-held and to-be-distributed loans, with loans intended for distribution carrying weaker structures.
- Inconsistent Disclosures: Preponderance of inadequate reporting and/or aggregation of enterprise-wide exposures.
- Repayment Source Identification: Insufficient documentation demonstrating deal sponsors or enterprise values as sources of repayment.

Five years removed from the crisis, leveraged lending is once again characterized by record issuance, fierce competition among lenders and erosion in underwriting and due diligence. Leveraged loan issuance rose rapidly in 2013, touching record highs and exceeding pre-crisis volumes. The average level of borrower leverage also rose, to an average of 5.3x in the second quarter of 2013, even as covenant-lite structures are also becoming more common.

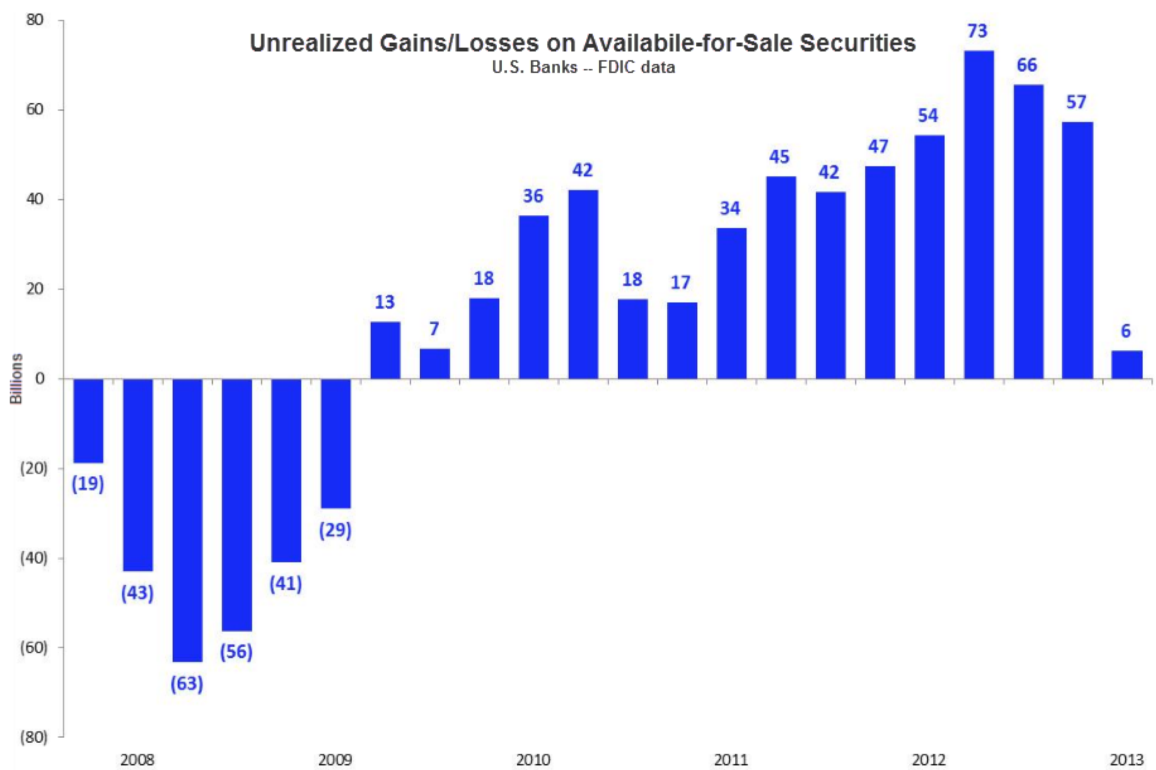
The Federal Reserve issued SR 13-3 in the first quarter of 2013 to address these and other shortcomings in leveraged lending practices. The related guidance is comprehensive and addresses aspects ranging from underwriting and leverage thresholds to portfolio management and stress testing. It applies not only to originating banks, but also to participants.

Key Provisions of SR 13-3	Defines and identifies leverage lending assets and aggregate borrower exposures. Some general guidelines are provided, but the onus is on institutions to develop their own definition.
	Requires underwriting to reflect a sustainable capital structure for borrowers, including the capacity to repay at least 50% of total debt (and 100% of senior debt) over a 5-7 year period, and a total leverage level of 6.0x total or 4.0x senior or less. Underwriting standards between held and distributed loans should not differ.
	Instructs institutions to develop and maintain credit policies, risk management practices, MIS, and stress testing commensurate with the institution's level of market participation, including not only held portfolios, but also origination pipelines.
	Requires thorough support and documentation of enterprise values and sponsor support when either is viewed as a repayment source. The income-based analysis of enterprise value is preferred.

Emerging Credit, Market and Liquidity Risk in the Investment Portfolio

Due to the low interest rate environment and low levels of attractive lending opportunities, banks may find incentives to take on more risk within investment portfolios in order to earn additional yield.

Bank managers have to carefully weigh the benefit of an increase in yield against an increase in interest rate risk associated with a portfolio's longer weighted average maturities (WAM). An increase in duration exposes the bank to additional interest rate risk in the event of a rising interest rate scenario. A recent report by the FDIC[1] noted call report filers experienced a $51 billion drop in the unrealized gains and losses on available-for-sale securities in the second quarter due in large part to rising interest rates. This was the biggest such decline on record since supervisors began collecting source data in 1994. Significant drops in market valuation of securities also increase liquidity risk at institutions that rely heavily on investment portfolios as a source of liquidity, for two primary reasons. First, declines in a portfolio's value reduce liquidity values of collateral in cases where securities are used to secure borrowing relationships. Secondly, the sale of securities carrying unrealized losses lowers the institution's earnings when those losses are realized.



Banks may also attempt to pick up yield in investment portfolios by purchasing complex instruments such as asset backed securities (ABS). Over the past year, there has been strong growth in a specific sector of the ABS market that includes structured pools of commercial and industrial loans called collateralized loan obligations (CLOs). Many bank managers consider CLOs issued after the financial crisis to be safer due to higher overcollateralization across all tranches, lower loan leverage ratios, and more investor control over

[1] Remarks by Martin J. Gruenberg, FDIC Chairman, August 29, 2013

loan restructuring. These recent changes to prevailing structures have led to a noticeable increase in the purchases of CLOs at banks. While the largest banks account for a bulk of the CLO purchase increase, small and large regional banks have also increased CLO holdings.

The CLO securities present banks with liquidity, market and credit risk. Liquidity may be reduced due to a lack of secondary sales, repo or secured borrowing markets. During macroeconomic stress events, illiquidity could greatly reduce the value of the securities. While bank managers may consider the credit risks of highly rated tranches to be lower post crisis, the risk is not completely eliminated. Due to increased demand, CLO structures include more loan collateral with weakened covenants. Bank managers should pay particular attention to the underwriting standards, loan collateral quality, and structure of any CLO considered for purchase.

The board of directors and senior management should understand investment portfolio strategies in order to monitor and control the changing risk profile of the securities under consideration for purchase. Appropriate pre-purchase analysis should be conducted on new security purchases in order to assess the risk in different economic conditions and interest rate scenarios, as outlined in SR Letter 12-15.

Emphasis on Model Risk Management

Statistical and financial models lie at the heart of many financial institutions' operations and decision-making, from forecasting borrower behavior to managing liquidity and evaluating strategies within investment portfolios. The use of such models has been common for many years, but the financial crisis demonstrated some key vulnerabilities for institutions that rely on them. As one key example, most pre-crisis mortgage-lending models failed to capture the likelihood and impacts of a severe downturn in real estate values. In the light of those and other model weaknesses, the Federal Reserve Board in 2011 issued SR 11-7 Guidance on Model Risk Management, noting "the use of models invariably presents model risk, which is the potential for adverse consequences from decisions based on incorrect or misused model outputs." To mitigate this potential risk, financial institutions need to evaluate and validate their models on an ongoing basis, not just at inception. The guidance acknowledges that model risk management will vary from institution to institution – by size, nature, complexity and model-use methods. But it is incumbent on all institutions under Federal Reserve supervision to evaluate their models in light of current emerging risks, including (but not limited to) the risks identified in this newsletter.